



## Legislative Fiscal Bureau

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February 10, 2021

TO: Members  
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Assembly Bill 3: Modification to the Tax Treatment of Tax-Option Corporations that Elect to Pay Tax at the Entity Level

Assembly Bill 3 (AB 3) was introduced on January 15, 2021, and referred to the Assembly Committee on Ways and Means. That Committee held a public hearing and executive session on AB 3 on January 21, 2021, at which that Committee recommended passage of the bill by a vote of 12-0. It was referred to the Joint Committee on Finance on February 8, 2021.

### **BACKGROUND**

#### **Treatment of Capital Gains**

Under Wisconsin law, a capital gains exclusion under the individual income tax is provided for 60% of the net capital gain from the sale of farm assets and 30% of the net capital gain from the sale of other assets, provided those assets are held more than one year (long-term capital gains) or are acquired from a decedent. Gains from assets held one year or less are fully taxed. The amount of net capital losses that may be used to offset ordinary income is limited to \$500 annually, with the remainder carried over to future years. For comparison, under federal law, long-term capital gains generally are fully taxable for federal purposes, and, if capital losses exceed gains, up to \$3,000 of those losses are allowed as a deduction against ordinary income, with the excess loss carried forward to be used in a later year. However, long-term capital gains are taxed at lower rates than ordinary income under federal law.

State law treats partnerships and S corporations that elect to be taxed at the entity level differently. Under current law, partnerships electing to be taxed at the entity level compute their net income in the same manner as an individual. As a result, partnerships may claim the 30% and 60% long-term capital gains deduction under the entity-level tax. Likewise, an electing partnership is subject to the \$500 Wisconsin net capital loss limitation.

By contrast, S corporations electing to pay tax at the entity level compute net income under the Internal Revenue Code (IRC). As discussed, the IRC does not provide for a 30% or 60% long-term capital gains deduction for S corporations. Likewise, the net capital loss limitation of \$3,000 provided under the IRC applies, rather than the \$500 net capital loss limitation under Wisconsin law.

### **Quarterly Payments**

Under current law, S corporations electing to pay tax at the entity level are required to make quarterly estimated payments in the same manner as C corporations. As a result, such S corporations are not required to pay interest on underpayments of estimated payments if their Wisconsin net income is less than \$250,000 for the current taxable year; thus, these S corporations are not required to pay quarterly estimated payments prior to their final payment when filing their tax return. Also, two different sets of rules for determining the amount of quarterly payments apply, depending on the amount of the S corporation's net income. In relevant part, if an S corporation has net income of less than \$250,000, then the amount of each quarterly installment payment is generally 25% of the lower of the following amounts: (a) 90% of the tax shown on the return for the taxable year or, if no return is filed, 90% of the tax for the taxable year; or (b) the tax shown on the return for the preceding year. S corporations having net incomes of more than \$250,000 may not use the second method in computing the installment amount.

By contrast, because partnerships electing to pay tax at the entity level are required to make estimated payments in the same manner as under the individual income tax, partnerships having net income of less than \$250,000 (but more than \$500) must pay 12% interest on any underpayment of estimated payments. Further, such partnerships make estimated payments in the manner consistent with C corporations and S corporations having incomes of less than \$250,000.

### **SUMMARY OF THE BILL**

The bill would provide for similar treatment of S corporations and partnerships electing to be taxed at the entity level with regards to capital gains and quarterly payments of tax.

Similar to the treatment allowed under current law provided for partnerships electing to be taxed at the entity level, the bill would allow electing S corporations to exclude from tax: (a) 30% of the net long-term capital gains realized from the sale of assets and the sale of all assets acquired from a decedent; and (b) 60% of the net long-term capital gains realized from the sale of farm assets and the sale of all farm assets acquired from a decedent. Likewise, the bill would limit the net capital loss limitation for electing S corporations from \$3,000 to \$500.

Similar to the treatment of partnerships, the bill would provide that the exemption to the requirement to pay interest on underpayments of estimated quarterly payments that is available to S corporations having net income of less than \$250,000 (but more than \$500) would not apply to S corporations electing to pay tax at the entity level. Finally, the bill would require S corporations to pay quarterly estimated payments according to the standards applicable to taxpayers with net income of less than \$250,000 regardless of their net income, similar to the treatment of partnerships.

These changes would first apply to taxable years beginning after December 31, 2019.

## **FISCAL EFFECT**

According to the Department of Revenue (DOR), based on a review of tax year 2019 returns that made the election to pay tax at the entity level, the bill would decrease revenues by an estimated \$580,000 in 2020-21, \$810,000 in 2021-22, and \$860,000 in 2022-23. In addition, there would be a minimal decrease in estimated segregated revenues collected under the economic development surcharge. DOR estimates that it would incur \$44,900 in administrative costs in 2021-22 to implement the changes.

Under s. 16.518 (3) of the statutes, if actual tax collections exceed the amounts estimated in the state's biennial budget act, one-half of such excess is deposited into the budget stabilization fund. On January 26, 2021, this office prepared a memorandum projecting general fund tax revenues for the remainder of 2020-21 and the 2021-23 biennium, and estimated that \$231.8 million would transfer into the budget stabilization fund in 2020-21, which would increase the total fund balance to \$993.9 million. Thus, the estimated effect of the bill on the budget stabilization fund would be a decrease in the estimated stabilization fund transfer of \$290,000 in 2020-21.

Under s. 16.47 (2), no bill containing an appropriation or increasing or decreasing state revenues in an annual amount exceeding \$10,000 can be passed by the Senate or the Assembly unless an emergency statement is attached to the bill. AB 3 would: (a) reduce state revenues by more than \$10,000; and (b) require an emergency statement prior to being passed in either House of the Legislature.

Prepared by: John D. Gentry